Jersey Funds Association

Accounting Update

Thursday, 22 June 2017

Building a better working world

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Deferred Tax and Investment Property

Deferred Tax and Investment Property
Reminders

Location of property

- It is important to consider the tax consequences in the location of the investment property
  - For example UK Residential properties are now subject to UK capital gains tax (CGT)
- This may trigger deferred tax recognition for both IFRS and FRS 102 reporters

Difference in accounting treatments under FRS 102

- Under previous UK GAAP fair value gains/losses were recognised outside of profit or loss and were therefore not subject to deferred tax
- However, under FRS 102 these fair value gains/losses are now required to be recognised in profit or loss, and are therefore subject to deferred tax under section 29
  - IFRS would also require recognition of deferred tax due to there being a temporary difference as a result of the fair value revaluation

Deferred Tax and Investment Property
Reminders

IAS 12 Income Taxes - recognition of deferred tax for a single asset in a corporate wrapper

- Accounting for deferred tax in the consolidated financial statements of the parent, when a subsidiary holds only one asset and the parent expects to recover the carrying amount of the asset by selling shares in the subsidiary
  - Required to account for deferred tax on the underlying asset of the subsidiary when preparing the consolidated accounts.

Preparing for new standards

Preparing for new standards
Overview of new pronouncements

New pronouncements effective for periods beginning on or after 1 January 2017, 2018 and 2019				
	2017	2018	2019	2021
IFRS 9 *Financial Instruments*		✓		
IFRS 15 *Revenue from Contracts with Customers*		✓		
IFRS 16 *Leases*			✓	
IFRS 17 *Insurance Contracts*				✓
Recognition of Deferred Tax Assets for Unrealised Losses (Amendments to IAS 12)	✓			
Disclosure Initiative (Amendments to IAS 7)	✓			
Classification and Measurement of Share-based Payment Transactions (Amendments to IFRS 2)		✓		
Transfers of Investment Property (Amendments to IAS 40)		✓		

Preparing for new standards

Overview of new pronouncements

New pronouncements effective for periods beginning on or after 1 January 2017, 2018 and 2019			
	2017	**2018**	**2019**
Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts* (Amendments to IFRS 4)		✓	
Foreign Currency Transactions and Advance Consideration (IFRIC Interpretation 22)		✓	
Annual Improvements 2014-2016:			
• IFRS 12 *Disclosure of Interests in Other Entities:* Clarification of the scope of the Standard	✓		
• IFRS 1 *First-time Adoption of International Financial Reporting Standards:* Deletion of short-term exemptions for first-time adopters		✓	
• IAS 28 *Investments in Associates and Joint Ventures:* Measuring an associate or joint venture at fair value		✓	

Preparing for new standards
IFRS requirements

- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires disclosure of the effects of recently issued accounting standards that are not yet effective, which includes disclosures of the:
  - Title of the new IFRS;
  - Nature of the impending change or changes in accounting policy;
  - Date by which application of the IFRS is required;
  - Date at which it plans to apply the IFRS initially; and
  - Expected impact or the fact that this is being evaluated.
- An entity's disclosures will need to evolve as more information about the standard's effect is known
- Entities are required to provide these disclosures until the standard is adopted
- There is no similar specific requirement for the interim condensed financial statements. However, IAS 34 *Interim Financial Reporting* requires updates of relevant information presented and disclosed in the most recent annual financial statements.
  - Regulators will likely expect updated entity-specific information to be disclosed that is sufficiently robust and detailed

Preparing for new standards
IFRS requirements

- Disclosures should relate to known or reasonably estimable information relevant to assessing the possible impact:
  - Qualitative disclosures, especially in the absence of sufficiently reliable quantitative information (early implementation stages);
  - Quantitative disclosures expected to increase while moving forward with implementation plans but in advance of the effective date
    - Many regulators now expect quantitative disclosures

Preparing for new standards

Regulators expectation of impact prior to adoption of IFRS 15 and IFRS 9

- ESMA has issued two public statements on issues for consideration in implementing IFRS 9 and IFRS 15
- The public statements focus on the level of disclosure to include prior to the adoption of IFRS 9 and IFRS 15
- And ESMA together with national competent authorities (like the FRC) will monitor the level of transparency from issuers of financial statements

- The objective of these requirements is to enable users of the financial statements to understand, beforehand, the impacts that the future application of the new Standards will have on the financial position and performance of the entity
  - ESMA also encourages issuers to explain the impact to risk management and/or APMs
- Information about the impact of IFRS 9 and IFRS 15 should become more reasonably estimable as implementation progresses

Preparing for new standards
Regulators expectation of impact prior to adoption of IFRS 15 and IFRS 9

- ESMA sets out illustrations of good practice at the different stages of implementation:
  - 2016 annual financial statements
  - 2017 interim financial statements
  - 2017 annual financial statements

Preparing for new standards
2016 annual financial statements

ESMA requirement	IFRS 15	IFRS 9
Detailed description and explanation on how key concepts will be implemented, highlighting differences to current approaches	Along the different revenue streams: Fund managers could consider including identification of performance obligations with respect to performance fees, how these obligations are satisfied and revenue subsequently recognized under IFRS 15.	Providing an explanation of the new approach to classification of debt instruments as fair value through profit or loss (i.e. based on two-test model as opposed to currently being designated as such due to being managed and performance evaluated on a fair value basis).
Timeline for implementation, including expected use of any of transition relief	Information on the transition approach (e.g. the cumulative catch-up transition method or the full retrospective application) and, for example, the practical expedient for completed contracts.	An explanation of the approach to comparative information at the date of initial application (i.e. an entity does not need to restate comparatives, but would instead adjust the opening retained earnings in the year of initial application).
If known or reasonably estimable, quantification of the possible impact of the application. And if not, additional qualitative information.	Either in relation to the amount or timing of the revenue recognised in relation to the different revenue streams.	On the financial position, financial performance and equity and, where relevant, capital planning.

Preparing for new standards
2017 financial statements

Interim

- Quantitative information on the impact of the transition could be provided if the issuer is able to provide significantly more specific information than previously provided

Annual

- Both IFRS 15 and IFRS 9 will be effective before the annual financial statements for 2017 will be published and therefore issuers should provide a quantitative assessment of the impact of the new Standards on their financial statements as of 1 January 2018
- Therefore, the 2017 annual financial statements are expected to:
  - Provide the quantitative impact of the application of the new Standards and explain the changes to the amounts reported under previously applied standards, disaggregated as appropriate;
  - Further develop and elaborate information already provided in previous financial statements taking into account the actual implementation of the new Standards

FRC's 2017/18 thematic reviews

EY

FRC's 2017/18 thematic reviews

- In 2017, the FRC will undertake thematic reviews of certain aspects of companies' corporate reports and audits, where it believes there is scope for improvement and particular shareholder interest, and will focus on:
  - Significant accounting judgments and sources of estimation uncertainty
  - Pension disclosures
  - Alternative Performance Measures (APMs)

Significant accounting judgments and sources of estimation uncertainty

- The FRC expects:
  - "Clear descriptions of the specific, material judgements made by the directors in applying accounting policies, clearly differentiating these from estimates;"
  - "Specific identification of the sources of estimation uncertainty that have the potential to change in the next year, with quantified explanations of the assumptions made about the future, for example, oil prices, and the carrying amounts that are subject to a significant risk of material adjustment within the next financial year"; and
  - "Where material, supplementary disclosures such as information about the sensitivity of estimates to changes in assumptions, the range of reasonably possible outcomes and changes made to past assumptions during the year".

Significant accounting judgements and estimates

Significant accounting judgments and estimates

Illustrative examples

Example	Judgement	Estimate
Deferred tax	Judgement is required when determining whether a deferred tax asset should be recognised (i.e. whether there will be sufficient future taxable profits).	Estimation is required in determining the amount of the deferred tax asset that should be recognised (i.e. estimation of the future profits that supported the recognition).
Investment property	Judgement is required to determine which valuation technique is most relevant for use in the circumstance. E.g. Sales or Yield method	If Sales method, then a possible estimate may be market comparable input. If Yield method, then the discount rate used is an example of an estimate.
Financial instruments	Judgment is required to determine which valuation approach is most appropriate/ relevant and has sufficient data available (e.g. market, income or cost approach).	Inputs such as volatility or credit risk into the valuation techniques may require estimation if they are not observable (i.e. level 2 and level 3).
IFRS 10 Investment entity	Judgement is required when considering whether the entity has the characteristics of an investment entity.	Estimation may be required when determining the fair value amount of its investments in subsidiaries (i.e. inputs into fair value measure).

Alternative Performance Measures (APMs)

Alternative Performance Measures

ESMA Guidance

- Effective for information published on or after 3 July 2016
- Applicable to disclosures in regulated information and prospectuses
  - Example of “regulated information” include the front sections of annual reports and half-yearly accounts
- Applies to entities whose securities are admitted to trading on an EU regulated market
- Definition of an APM:
  - For the purpose of these guidelines an APM is understood as a financial measure of historical or future financial performance, financial position, or cash flows, other than a financial measure defined or specified in the applicable financial reporting framework.
- Derogation for APMs included within the financial statements
- Common examples of APMs for Funds
  - NAV per Share, Total Return (adjusted for dividends), Ongoing Charges
- Where this is disclosed on the balance sheet (included within the financial statements), it would <u>not</u> be required to comply with APM guidance

Alternative Performance Measures

ESMA Guidance

- Reporting requirements for APMs:
  - A reconciliation of the APM to the most directly reconcilable line item, subtotal or total presented in the financial statements (including comparatives)
  - Explain the relevance of APMs in order to allow users to understand their relevance and reliability
  - APMs should not be displayed with more prominence, emphasis or authority than measures directly stemming from financial statements.
  - The definition and calculation of an APM should be consistent over time (any changes require explanation)

- FRC released a "FAQ" document in May 2016, providing additional guidance for directors, and explaining how compliance will be monitored / implemented in the UK

Alternative Performance Measures

ESMA Guidance

- As noted where a Fund presents NAV per Share on the face of the balance sheet or in a note to the financial statements, it is not required to comply with APM guidance, however:
  - When presenting financial statements under IFRS or FRS 102 comparatives would be required;
  - Funds would generally disclose how the amount is calculated (particularly in multi-class funds)

- A number of Funds disclose Total Return and Ongoing Charges in the Front Section only, both of which would generally meet the definition of an APM
  - The difficulty with these measures is calculating the numerator is possible, however it is very difficult to determine the numerator
  - In the Total Return, the denominator of average number of shares is adjusted as though the dividend is reinvested
  - In this case it is possible for the explanation to also meet the requirements of the reconciliation, provided the disclosure is sufficiently clear

General Partners Profit Shares

General Partners Profit Shares

Accounting for General Partners (GP) Profit Share

- Issue arising in relation to the drafting of certain Limited Partnership Agreements (LPAs)
- Occurs due to differing tax treatment for UK domiciled GPs when they receive “Priority Profit Share”
- LPA drafted stating that where the LP has not generated sufficient profits, that amounts paid to the GP will be considered as an interest free loan until such time the LP generates sufficient profits
- However the terms of such loan, is that they will never be repaid
  - Implication under both IFRS and FRS 102, such “interest free loans” would not meet the definition a financial instrument
- In a number of financial statements, the interest free loan has been treated on its legal form
  - i.e. GP records loan liability (Dr Cash, CR Liability), and LP records loan asset (Dr Asset, Cr Cash)
- Accounting analysis would be that neither the GP liability or the LP asset should be recorded

UK GAAP Update

UK GAAP Update

Amendments relevant for 2016 / 2017 financial statements

Amendments to FRS 102 relevant for Funds

- *Fair Value hierarchy*, disclosure requirement amended to:
  - Align the fair value hierarchy disclosures as would be required under IFRS 13
  - Amendment effective for periods commencing 1 January 2017
  - Early adoption is permitted, provided that fact is disclosed

- *Definition of Related Parties*, amended to include:
  - *(viii) the entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.*
  - This aligns to the IFRS definition, which would generally mean a fund manager would be considered to be a related party to the Fund
  - Amendment effective for periods commencing 1 January 2016

Fair Value hierarchy

- The table below summarises the requirements for the fair value hierarchy disclosures under IFRS, FRS 102 and the IA and AIC SORPs, prior to applying the FRS 102 amendment:

	IFRS	Old FRS 102	SORPs
Quoted Price for identical asset	Level 1	Level a)	Req'd
Price of recent transaction	N/a	Level b)	Req'd
Valuation technique (observable)	Level 2	Level c) *	Req'd
Valuation technique (unobservable)	Level 3	Level c) *	Req'd

* Under FRS 102, level c) applied to all valuation techniques, i.e. there was no requirement to split between observable and unobservable inputs

UK GAAP Update
Amendments relevant for 2016 / 2017 financial statements

"Association of Investment Companies" (AIC) – amended SORP

- The Financial Reporting Council (FRC) have changed the policy in relation to SORPs to allow for "consequential amendments"
  - As a result, the AIC issued an updated version of the 2014 SORP in January 2017 with the main change being in relation to the fair value hierarchy

Fair Value hierarchy

- The 2014 SORP dealt with the inconsistency between FRS 102 and IFRS, by requiring level c) to be split creating a four tier hierarchy (refer previous slide)
- The 2017 SORP, removes the requirement upon adoption of the amendment to FRS 102

Related Party definition

- The SORP was not amended for the change in FRS 102 definition
  - At paragraph 62 it states that "it would be rare for the management company to be a related party as defined in FRS 102"
  - However similar disclosures would be required under paragraph 61 (although not the full disclosures required for a related party)

UK GAAP Update
Amendments relevant for 2016 / 2017 financial statements

“Investment Association” (formerly IMA) – Additional Guidance

- As a result of the FRS 102 amendments, the Investment Association released additional guidance for “Financial Statements of UK Authorised Funds”

Fair Value hierarchy

- The additional guidance did not address the change in fair value hierarchy
- Given SORPs are issued to provide guidance on applying accounting standards requirements (i.e. are not setting additional requirements), expectation that Fund adopting the amendment would follow the new three tier hierarchy

Related Party definition

- The SORP was amended for the change in FRS 102 definition as follows:
  - “In July 2015 the FRC issued amendments to FRS 102 that changed the definition of a related party. As a result, the authorised fund manager will come to be regarded as a related party because it provides key management personnel services to the authorised fund. The amendment is applicable to accounting periods beginning on or after 1 January 2016 with earlier application permitted.

UK GAAP Update
Potential amendments on the horizon

FRED 67 “Triennial review 2017”

- Comments due: 30 June 2017
- Effective date will be periods beginning on/after 1 January 2019
- Early adoption likely to be permitted

Key changes for funds

- Financial Instruments (there are a number of amendments/changes proposed)
  - IAS 39 will continue to be available as an accounting policy choice for financial instruments after 2018
  - Use version of IAS 39 which applied immediately prior to IFRS 9 being adopted
- Cash Flow Statement
  - Disclose an analysis of changes in ‘net debt’ (i.e. borrowings of an entity together with any related derivatives, and obligations under finance leases, less any cash and cash equivalents)
- Investment Property
  - Removal of undue cost/effort exemption from FV measurement

US GAAP Update

US GAAP Update

Fair Value hierarchy

- ASC 2015-07 amends the disclosure requirements in relation to the fair value hierarchy under ASC 820
- Where an entity measures an investment using the NAV as a practical expedient, they are no longer required to include those investments in the 3 level hierarchy disclosure
- Required to disclose the amount of investments measured using the NAV practical expedient (to enable reconciliation of fair value hierarchy to the financial statements)
- Applicable for periods ended 15 December 2015 for "public business entities", 15 December 2016 for all others, early adoption is permitted

- Note under IFRS, no equivalent practical expedient is permitted for measuring investments at NAV, accordingly entities will continue to be required to determine whether investments measured at NAV is representative of fair value, and what level of the hierarchy the resulting fair value should be categorised

IFRS Update

IFRS Update

Amendments to IAS 7 *Statement of Cash Flows*

- Amendments to IAS 7 are part of the IASB's Disclosure Initiative and are intended to provide information to help investors better understand changes in an entity's debt.
- Effective for annual periods beginning on or after 1 January 2017.
- The key requirements of the amendments to IAS 7 help users of financial statements better understand changes in an entity's debt
- The amendments require entities to provide disclosures about changes in their <u>liabilities arising from financing activities</u>, including both changes arising from
  - cash flows and
  - non-cash changes (such as foreign exchange gains or losses).
- Early application is permitted and on initial application of the amendment, entities are <u>not required</u> to provide comparative information for preceding periods.
- This reconciliation is similar to the "net debt" reconciliation requirement under FRS 1 however differs in terms of what is reconciled
  - IAS 7 – liabilities that have been or would be classified as financing activities in the CFS
  - FRS 1 – net debt is considered borrowings (comprising capital instruments classified as liabilities together with related derivatives, and obligations under finance leases) less cash and liquid resources

Corporate Governance

Corporate Governance
Viability Statements

Viability Statement

- Applies to companies that apply the 2014 or 2016 “UK Corporate Governance Code”, either as a result of a premium equity listing on the London Stock Exchange (LSE) or voluntarily
- Code C.2.2 states that the Board:
  - Taking account of the company’s current position and principal risks, the directors should explain in the annual report how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. The directors should state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.
- FRC “Guidance on Risk Management, Internal Control and Related Financial and Business Reporting” recommends the inclusion of sensitivity analysis and details of any assumptions

Corporate Governance
Viability Statements – Case Study

Viability Statement – Cobham plc, year ended 31 December 2015

- 2015 annual report dated 2 March 2016
- Extracts from Viability Statement – "Assessing viability"
  - *… the Directors took into account the potential impact of the principal risk events identified in the strategic planning process that could prevent the Group from achieving its strategic objectives.*
  - *Sensitivity analyses were run to model the financial and operational impact of plausible downside scenarios of these risk events occurring individually or in combination.*
  - *… the Directors have been able to conclude that the Group will be able to operate within its existing bank covenants and maintain sufficient bank facilities to meet its funding needs over the three-year period. In coming to this conclusion, it has been assumed that a successful renewal including the £300m of mixed currency bank facilities is achieved in October 2018.*

- The last principal risk was in relation to "Deterioration in trading performance or in cash generation leading to higher debt and increased gearing", in the description there was no mention of debt covenants.

Corporate Governance
Viability Statements – Case Study

Viability Statement – Cobham plc, year ended 31 December 2015

- 26 April 2016
  - First quarter trading was behind the Board's expectations. … operational issues in the Wireless business … and a one-off charge of £9m; increasing headwinds in the commercial fly-in fly-out business; and cost increases on a small number of development programmes in the Advanced Electronics Solutions Sector.
  - … the Group's leverage could be close to the net debt to EBITDA covenant ratio of 3.5x at 30 June 2016, the next covenant testing date. … Group's best interests to reduce indebtedness on a more long term basis. … decided to raise sufficient new equity to reduce the net debt to EBITDA ratio to around 2x.
  - … new equity finance [to] be raised by way of a rights issue of approximately £500m during the second quarter of 2016 …
- In effect the company had to raise finance to avoid potentially breaching debt covenants, however there was no mention of the impact of debt covenants in the viability statement issued less than two months previously.

Note: 2016 Annual report included a new principal risk “Borrowing agreements contain covenants that may not be complied with and may not generate sufficient liquidity”!

Corporate Governance
Viability Statements – Case Study Summary

Viability Statement – Cobham plc, year ended 31 December 2015

- There is no change in the requirements for 2016 (nor will there be on adoption of the new 2016 Code)
- The example demonstrates the importance of revisiting principal risks on a regular basis [Code provision C.2.1 requires a robust assessment of principal risks]
- The Board is required to perform an annual review of the effectiveness of internal controls [Code provision C.2.3]
  - A review of the principal risks is recommended [Guidance on Risk Management, Internal Control and Related Financial and Business Reporting, paragraph 43]
- Generally principal risks will change over time, therefore the expectation is these changes will be reflected in the viability statement over time

Corporate Governance
Changes to UK Corporate Governance Code

2016 UK Corporate Governance Code

- Effective for accounting periods commencing on or after 17 June 2016
- Minor changes as follows:
  - Amendment to C.3.1 – “The audit committee as a whole shall have competence relevant to the sector in which the company operates.”
  - Removal of FTSE 350 tender requirement from C.3.7.
  - Amendment to C.3.8. – “advance notice of any retendering plans”

- Audit Committee composition (C.3.1)
  - The requirement is not that the audit committee must have audit or accounting experience
  - What it requires is a consideration of experience in the funds sector
  - This may require further consideration of the type of assets the fund invests in, e.g.
    - Real Estate fund, may consider the need for a Chartered Surveyor with valuation experience to be included on the audit committee;
    - Timber fund, may consider the need for someone with specific timber industry experience to be included, etc.

Corporate Governance
Changes to UK Corporate Governance Code

2016 UK Corporate Governance Code

- Audit Tendering requirements (C.3.7 and C.3.8)
  - The reason for the change in tender requirements is as a result of a law change requiring mandatory tendering for FTSE 350 UK incorporated companies
  - Under the 2014 Code, a Channel Islands incorporated FTSE 350 company was “required” to put the audit out to tender every ten years
    - Remember UK Corporate Governance Code has a “comply” or “explain” concept
  - Under the 2016 Code, there is now no requirement to put the audit up for tender
    - This means for a Channel Islands company following the Corporate Governance Code, the only reporting requirement in relation to audit tendering is to give advance notice of an intention to do so

Presenters

Chris Matthews

Partner

+44 (0) 1534 288610 | cmatthews@uk.ey.com

Matthew Ryan

Senior Manager

+44 (0) 1534 288632 | mryan3@uk.ey.com

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